

Taxes

An Overview of Key U.S. Tax Considerations for Inbound Investment



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As the world's largest economy, the United States provides tremendous operating and investment opportunities, with an innovative and productive workforce, robust infrastructure, and lucrative markets. However, foreign businesses interested in investing in the United States can find it daunting to navigate the U.S. federal tax code and regulations, as well as state and local taxes. Inadequate preparation can create undue risk, result in increased and unanticipated tax costs, and ultimately impact the overall success of U.S. operations. In addition, overlooking potentially valuable tax and financial benefits, including federal, state, and local credits and incentives, can result in missed opportunities to reduce tax costs and benefit from capital and operational cost offsets.*

This chapter is intended to provide businesses interested in investing in the United States with some general guidance about various levels of U.S. tax imposed on non-U.S. investors, as well as available government incentives. It is critical to consult with a qualified advisor before making any business or tax-related decisions to more fully understand the impact of those decisions on the specific facts of the investment.

The Fundamentals of U.S. Federal Tax

Who must pay?

U.S. tax-resident individuals, citizens, corporations, and their foreign branches are subject to U.S. federal tax (and potentially state and local taxes) on their worldwide income. Conversely, non-U.S. tax resident individuals and non-U.S. corporations and partnerships are generally only subject to U.S. tax on income that is "effectively connected to a U.S. trade or business" (referred to as ECI) and U.S. source income that is "fixed, determinable, annual, or periodical" (FDAP). FDAP income generally includes U.S. source interest, dividends, rents, and royalties.

ECI must be associated with U.S.-based activity that rises to the level of a U.S. trade or business. Although the U.S. tax code does not define a U.S. trade or business, case law generally frames it as activity in pursuit of profit that is "considerable, continuous, regular, and substantial." If the foreign parent or subsidiary is resident in a country that has an income tax treaty with the United States, business profits are subject to U.S. federal income tax only to the extent that the income is attributable to a U.S. permanent establishment (PE). In general, a PE requires a more permanent business connection with the United States, so it is possible that a non-U.S. company could carry on a U.S. trade or business that does not rise to the level of a U.S. PE (and therefore is not liable for federal income tax).

* The views expressed are those of the authors and do not necessarily represent the views of Ernst & Young LLP or any other member firm of the global EY organization.

How much is the tax?

For non-U.S. corporations, ECI is subject to federal tax at the same rate as applies to U.S. domestic corporations.

In addition to federal taxes, there may also be applicable state and local taxes on a non-U.S. corporation's U.S. business income, discussed further below. A deduction is generally available on the federal income tax return for all state and local taxes; thus, despite the addition of state and local taxes, it is not unusual for a corporation to have a U.S. effective marginal tax rate of approximately 25 percent.

Tax on FDAP is withheld by the payor on a gross basis at a 30 percent rate, though this rate can be reduced (potentially to zero) under an applicable U.S. income tax treaty if the income recipient is eligible for treaty benefits. Certain exceptions to FDAP withholding tax may also be available under federal law.

Corporate tax rates at a glance

<i>Nature of tax</i>	<i>Rate</i>
Corporate income tax	21%
Capital gains	21%
State and local income taxes	Varies by state from 0% to 13%, but generally deductible against federal income tax
FDAP withholding taxes, including dividends, interest, rents, royalties	30% (applicable to non-U.S. recipients) - note this may be reduced under an applicable treaty
Branch profits tax	30% (applicable to non-U.S. recipients) - note this may be reduced under an applicable treaty

**Additional taxes, including federal payroll taxes, duties and customs and a variety of other state and local taxes, may apply.*

Choice of Entity

There are various ways a non-U.S. company can structure its U.S. business. The choice may be driven by customer requirements, business and commercial needs, though U.S. and non-U.S. taxes can also play a role. Typical business models include a representative office, branch office, or wholly owned subsidiary. Each has its own implications and compliance requirements for U.S. tax purposes; this discussion focuses on tax considerations associated with the models.

A representative office is the easiest option for a company just starting to do business in the U.S., and it may not trigger U.S. federal corporate income tax if the U.S. activities are very limited. A representative office may be appropriate for the very early stages of a

company's U.S. expansion but will likely need to be transitioned into a branch or subsidiary as the U.S. business grows.

A branch structure is similar to a representative office in that it does not require incorporating a separate legal entity, but a branch can perform a substantially broader range of activities than a representative office. A branch will, however, constitute a taxable presence in the U.S., which means that the business must annually account for and file U.S. federal income tax on the branch's profits. The parent company of the branch will be considered the U.S. taxpayer, and, as such, the parent company's other operating income could potentially be pulled into the U.S. tax net in certain circumstances. It is important that all related party transactions between the U.S. branch and the parent company are based on arm's length U.S. transfer pricing principles.

Non-U.S. companies that intend to have people or property in the United States often choose to incorporate a wholly owned U.S. subsidiary to "ring fence" the U.S.-based activities. A subsidiary does not have to necessarily be incorporated in the state in which it is primarily doing business. It is common to incorporate in a state with flexible incorporation laws and then operate in many other states, which may require registering the corporation to do business in those other states and applying for a certificate of authority to do business there. As with branch structures, it is important that all related party transactions with the U.S. subsidiary are based on arm's length U.S. transfer pricing principles to control the amount of profits subject to U.S. tax.

Considerations associated with typical U.S. operating models

<i>Considerations</i>	<i>U.S. representative office</i>	<i>U.S. branch</i>	<i>U.S. corporate subsidiary</i>
Allowed functions	Activities are limited to ancillary and support activities such as advertising and market research.	No specific restrictions apply to U.S. branch operations.	No specific restrictions apply to corporate subsidiaries, though all related party cross-border activities should use U.S. transfer pricing arm's length principles.
U.S. federal income tax	If activities are sufficiently limited, the representative office should not be subject to U.S. federal income tax.	Branch profits that are ECI are taxed at the 21 percent corporate tax rate.	Taxed at the 21 percent corporate tax rate.

Dividends	The representative office should not be able to pay dividends.	A 30 percent branch profits tax on deemed withdrawals from the branch (potentially reduced/eliminated under treaty).	30 percent dividends withholding tax (potentially reduced/eliminated under treaty).
State and local taxation	Varies depending on state tax nexus profile.	Varies depending on state tax nexus profile.	Varies depending on state tax nexus profile.

Alternatively, some non-U.S. companies choose to operate through a U.S. limited liability company (LLC). For U.S. federal income tax purposes an LLC can elect different tax classifications. For example, an LLC with a single owner is, by default, classified as a disregarded entity (the equivalent of being classified as a branch) for U.S. tax purposes, unless the owner elects to treat it as a corporation. Likewise, an LLC with more than one owner is classified as a partnership, unless the owners elect to treat it as a corporation. These rules are commonly referred to as the “check-the-box” rules. Before choosing to use an LLC for U.S. business purposes, the non-U.S. company should carefully consider local country treatment of the LLC (such as whether it could be considered a hybrid entity).

Financing U.S. Operations

U.S. operations can be funded via debt, equity, or a mix of debt and equity, though it is recommended that U.S. operations not be fully funded by debt. Although interest expense is generally deductible, the U.S. tax code imposes various restrictions on deductibility. In addition, the Internal Revenue Service (IRS) can recharacterize purported debt as equity for U.S. tax purposes, which could potentially lead to disallowed interest deductions and/or additional withholding tax liability.

Interest paid to a non-U.S. creditor is generally subject to a 30 percent rate of U.S. federal tax through the application of the FDAP withholding regime described above. This rate may be reduced (potentially to zero) if the creditor is eligible for benefits under an applicable U.S. income tax treaty. Certain exceptions to withholding are also available under federal law. Note that most U.S. tax treaties contain a “limitation on benefits” article (an anti-treaty shopping provision) that limits treaty benefits to persons that have a measurable business nexus to their country of incorporation (for example, the country of residence of the ultimate owners, or the conduct of an active trade or business in the country where the non-U.S. company is resident). Eligibility for a reduced rate of federal tax on interest

payments, whether the reduction is based on federal law or a tax treaty, should be confirmed prior to entering into any financing arrangements.

Repatriation of U.S. Earnings

Once U.S. operations become profitable, consideration should be given to how best to repatriate the cash to the home office. If a U.S. corporate subsidiary is established, dividends paid to the non-U.S. parent company are generally subject to a 30 percent rate of U.S. federal tax under the FDAP withholding regime described above. The 30 percent rate may be reduced (potentially to zero) under an applicable U.S. income tax treaty if the recipient is eligible for treaty benefits. For non-U.S. companies that are operating in branch form in the U.S., a federal branch profits tax imposes similar withholding (and relief from branch profits tax may also be available under a U.S. income tax treaty).

In some cases, a non-U.S. company may choose to utilize debt to fund U.S. operations to repatriate cash back to the home country office if the federal withholding tax rate on interest is less than the federal withholding tax rate on dividends.

State, Local, and Other Taxes

In addition to the activities and structures that generate U.S. federal income tax liability, inbound companies (depending upon where they locate, how they conduct their business, and to whom they sell their products) can also be subject to subnational state and local income taxes, as well as certain non-income taxes, such as sales and use taxes, gross receipts taxes, real and personal property taxes, unemployment and payroll taxes, among others.

State income taxes

Non-U.S. companies expanding into the United States may be surprised to learn that they may be subject to state income taxes not only in their state of incorporation, but in other states as well. States generally impose tax when a company creates state tax “nexus” in the state. Nexus is generally formed when a company has people or property in a state,

even temporarily (and increasingly, some states also have economic nexus rules whereby a liability could exist even without people or property in that state so long as the company has made a threshold level of sales to the state). As such, it is possible for a non-U.S. company to create state tax nexus in multiple states.



Although most states use federal taxable income as a starting point for calculating the state tax liability, each state may provide significant additions to, or subtractions from, that amount to determine state taxable income. States typically do not allow the same amount of depreciation and usually will add back state and local taxes, among other items, to determine the state tax base. Thus, the state income tax base could vary widely from state to state. In addition, and quite unusual compared to other countries around the globe, the states rely upon formulary apportionment to divide the tax base of a multi-state business. In the past, most states used a blended factor comparing the ratio of property, payroll, and sales in the state compared to everywhere the taxpayer was engaged in business. Now, increasingly the states rely solely upon a sales factor to apportion the tax base among the states. In some cases, certain types of income, such as income from the sale of real property located in the state or from certain intangible income, is allocated entirely to one state, although these rules vary from state to state. In theory, there should not be double taxation amongst the states as the total income of a company should be allocated and apportioned amongst the states where the company has created nexus, but because there is no mechanism among the states to settle double taxation disputes, it is possible that a single stream of income could be subject to taxation by more than one state.

In general, states may choose whether to conform to the federal Internal Revenue Code (IRC) and may even pick and choose which parts of the IRC to which they wish to conform. Some states opt for “fixed date” conformity, which means that they follow the IRC as of a certain date. Some states choose “selective” conformity and adopt only certain IRC provisions or conform to those provisions at different times compared to their original date of adoption for federal income tax purposes. Others practice “rolling” conformity, automatically updating their reference to the IRC on a continual basis and thus conforming to the most recent version of the IRC as it is amended.

In addition, it is possible to create state tax nexus (and thus a state tax liability) even if there is no federal tax due, such as when a treaty eliminates the federal tax liability, because U.S. tax treaties are limited by their terms solely to the U.S. federal income tax (other than the non-discrimination provisions). Thus, non-U.S. companies should be aware that if they believe they do not have a U.S. PE and are thus not subject to U.S. federal income tax, they may still have sufficient state nexus to be subject to state income taxation. These rules governing tax presence vary widely from state to state and, notably, even with respect to particular state or local taxes within a single state.

Sales and use taxes

Unlike many other countries, the United States does not impose a national sales tax or value-added tax (VAT). Instead, such consumption-based taxes, known as sales and use taxes [but which may go by other names such as a “general excise tax” (in Hawaii) or a “transaction privilege tax” (in Arizona)], are levied in all but five states. In most states, in

In addition to the state-wide sales tax, counties, cities, and other local regional authorities are entitled to levy their own sales and use taxes. Fortunately, in most states, these additional local jurisdictional sales and use taxes are merely imposed as an incremental addition to the existing state sales tax base and collected by the same state taxing authority. However, in certain states, some local “home” rule jurisdictions are granted the authority to administer their own sales and use taxes separately from the state, meaning that they may have a tax base that is different from the state’s and may require taxpayers to file and report such local taxes separately as well. Sales taxes are typically assessed on the final consumer purchase, with wholesale transactions usually exempted. Generally, all sales of tangible personal property occurring within a state are subject to sales tax unless specifically exempted by statute. In most states, sales of services and intangible property (such as electronically delivered software) are usually excluded from sales tax unless specifically taxable. It is the seller’s responsibility to collect and remit sales tax, although state and local law typically allows the cost to be transferred to the consumer.

Prior to the 2018 U.S. Supreme Court ruling in *South Dakota vs. Wayfair, Inc. (Wayfair)*,⁶ a company generally needed to have a physical presence in a state to trigger an obligation to levy and remit sales tax on sales within a state. The *Wayfair* ruling eliminated the physical presence standard, meaning sellers may be required to collect sales tax on transactions with remote consumers that previously were not subject to sales tax. After the *Wayfair* ruling, many states enacted presence thresholds for sales and use tax purposes that apply depending on the dollar amount of sales and/or number of transactions within the state (typically either \$100,000 or more of revenues derived from sales to consumers in the state, or 200 or more transactions with consumers located in the state, although these thresholds vary from state to state). Moreover, in response to the rapid development of online retailers who allow third-party retailers to sell through their internet portals, nearly every state now imposes a sales tax collection responsibility on the operators of the internet sales portals.

Non-U.S. companies selling into the United States (including those without a physical presence in the United States) should assess their potential sales tax obligations following the *Wayfair* ruling and the ongoing changes in state and local tax laws in response to that ruling, and ensure they have compliance and reporting processes in place to satisfy any obligations. Even though the state and local taxing authorities may not have an immediate ability to enforce collection, the failure to file returns means that the statute of limitations for sales tax collection assessments remains open indefinitely. Non-U.S. companies that do

⁶ *South Dakota v. Wayfair, Inc.*, 585 U.S. ___, 138 S.Ct. 2080 (2018).

not comply may later be surprised to learn they have significant state and local sales tax liabilities.

Employment taxes

Human capital is an area that can become quite challenging for an inbound company, especially if the home country headquarters is left to deal with the diverse and often complex requirements of federal and multistate taxing jurisdictions. Many businesses coming to the United States decide to outsource some or all of their human resource management activities such as payroll and benefits administration since these areas require considerable local knowledge.



1. Social security tax

Under the Federal Insurance Contributions Act (FICA), social security tax is imposed on wages or salaries received by individual employees to fund retirement benefits paid by the federal government. For 2020, the social security tax is 15.3 percent. Half of the tax (7.65 percent) is withheld from the employee's wages and half (7.65 percent) is paid by the employer. The portion relating to the social security portion of the federal tax is subject to a wage limitation that periodically changes while the portion relating to the federal Medicare program (1.45 percent imposed on each of the employer and the employee) is not subject to any such limitation.

2. Federal unemployment tax

Federal unemployment tax (FUTA) is imposed on the wage payments that employers make to their employees for services performed within the United States regardless of the citizenship or residency of the employer or employee. The 2020 projected tax rate is 6 percent on the first \$7,000 of wages of each employee. Connected to this federal unemployment insurance program, most states also impose their own unemployment taxes that are creditable against FUTA tax when paid; rates vary from state to state as well as on the historic unemployment performance of each particular employer.

3. Employer reporting and withholding

An employer (whether a domestic or foreign United States employer) is responsible for withholding and remitting United States federal, state, and local income and social security taxes from the wages of resident and nonresident alien employees. The

employer is also responsible for reporting the compensation income of its employees working in the United States.

Federal, state, and local credits and incentives

Although the U.S. network of federal, state, and local taxes can be complex to navigate, there are also federal, state, and local incentives available for inbound investors where the investment involves material capital investment, research and innovation, or leads to job creation. These can include tax credits, abatements, cash grants, land grants, low interest loans, and other benefits. Companies should consider a strategy for identifying and securing these investment incentives as they can help mitigate upfront costs and ongoing operational costs associated with investing in the United States, as well as strengthen the inbound investor's relationship with the U.S. communities in which it does business.

Glossary

Branch profits tax (BPT): The branch profits tax, which simulates the tax treatment of a corporation that issues dividends, is a 30 percent U.S. federal tax on deemed withdrawals from a branch. The tax base for the branch profits tax is the dividend equivalent amount, which is essentially the branch earnings for the year less the amounts reinvested in the United States. In some cases, the 30 percent branch profits tax can be reduced or eliminated by treaty.

C corporation: Under U.S. law, most corporations are established in accordance with the law of the state of incorporation. Although the corporate laws of most states are similar, those of certain states are more flexible than others. A corporation has a separate legal identity distinct from its shareholders. This can be used to cap any risks that may be inherent in a branch or partnership. A "C corporation" is a reference to the United States federal income tax treatment of a corporation under Subchapter C of the IRC. Most corporations are treated as "C corporations" unless special elections or qualifications apply. Use of a C corporation also prevents United States profits and losses from flowing up to the shareholders. The profits earned by a C corporation are subject to a 21 percent federal income tax rate (plus any applicable state and local taxes) in the United States.

Effectively connected income (ECI): Income that is effectively connected to a U.S. trade or business associated with activity that is considerable, continuous, regular, and substantial. ECI is generally used to determine what foreign corporations and their U.S. branches and partnerships are subject to U.S. tax.

Fixed, determinable, annual, or periodic income (FDAP): Includes dividends, interest, rents, and royalties; generally excludes gains from the sale of real or personal property.

Federal Insurance Contributions Act (FICA): A social tax imposed on wages or salaries received by individual employees to fund retirement benefits paid by the U.S. federal government.

Federal unemployment tax (FUTA): Imposed on the wage payments employers make to their employees, regardless of the citizenship or residency, for services performed within the United States.

Internal Revenue Code (IRC) of 1986, as amended: The basic federal income tax law for the United States.

Internal Revenue Service (IRS): The agency of the U.S. federal government responsible for enforcing U.S. federal tax laws, collecting taxes, processing tax returns, and issuing tax refunds.

Limited liability company (LLC): An entity created under state law. From a U.S. federal income tax perspective, an LLC is an eligible entity that can be treated as either a partnership, a corporation, or a disregarded entity. An LLC may be disregarded only if it has a single member (i.e., owner). If it has two or more members, unless it elects to be treated as a corporation, an LLC is treated as a partnership for U.S. federal income tax purposes (provided it does not engage in certain businesses for which such an election is not permitted). From a state business law perspective, LLCs provide their members with liability protection similar to that offered to shareholders by being organized in corporate form.

Permanent establishment (PE): A fixed place of business through which the business of an enterprise is wholly or partly carried on, which most U.S. double tax treaties say includes a place of management, a branch, an office, or a factory.

Sales and use tax: Sales and use taxes in the United States are generally assessed at the state and/or local level and are usually assessed on the final consumer purchase, with wholesale transactions remaining tax exempt. As a general rule, all sales of tangible personal property are subject to sales or use tax unless specifically exempted by statute (sales of services and intangible property vary by state). Use taxes are imposed on the use, storage, or consumption of tangible personal property by a business itself, within a state's borders.

State tax nexus: Generally refers to the requisite business activity in a state or local taxing jurisdiction sufficient to allow a state to impose an obligation to pay or collect and remit a tax. Based on U.S. Supreme Court rulings, state tax nexus can be limited by provisions of the U.S. Constitution. Moreover, state laws may also establish the thresholds by which a taxpayer may have sufficient connections to the state to be subject to a state tax payment or collection obligation [generally based upon physical presence, such as the presence

(even on a temporary basis) of employees or independent contractors in the state, leased property in the state, or based on the dollar amount or number of transactions occurring in the state]. Such rules vary from state to state and also, even within the same state, based upon the type of tax. As indicated elsewhere, U.S. income tax treaties by their very terms do not apply to the states. Consequently, even though a non-U.S. company may not have a PE in the United States due to the invocation of treaty protection, it may still have “state tax nexus” and an obligation to pay or remit certain state or local taxes.

U.S. trade or business: There is no comprehensive definition of a U.S. trade or business; it is largely defined by case law. In order to make a determination of whether a trade or business exists, the owner’s level of activity must be measured. Activity in pursuit of profit that is “considerable, continuous, and regular” is necessary to establish a trade or business.

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